Real Estate

Principal Asset Management℠

THE CASE FOR COMMERCIAL MORTGAGE-BACKED SECURITIES

A timely opportunity to improve portfolio outcomes

Rising rates, restrictive monetary policy, and uncertain growth prospects have pushed real estate risk premiums higher. Compelling yields, defensive positioning, and more responsive public market pricing favor public real estate debt.

As volatility increases, so does the need for thoughtful portfolio construction.

The commercial mortgage-backed securities (CMBS) sector offers the opportunity to improve your portfolio outcomes through:

1. Flexible positioning
2. Yield enhancement
3. Diversification benefits

CMBS defined

CMBS are bonds secured by commercial real estate mortgages from properties located across the United States.

The sector spans commercial real estate and fixed income. It is an efficient investment in real estate debt, and a component of the Bloomberg U.S. Aggregate Index.

1 FLEXIBLE POSITIONING

Volatile markets and evolving economic outlooks put a premium on investment flexibility. But to be valuable for investors, that flexibility must come with liquidity.

CMBS has the potential to provide both. Investors have the potential to gain flexibility with a wide range of risk-return, collateral, and duration profiles. The sector's liquidity comes from being traded in public markets via dedicated trading desks across major banks and regional brokers, as well as in an active new-issue market.

CMBS comes in a variety of forms

Conduit CMBS
Diversified pools of mortgages on office, retail, industrial, hotel, and apartment properties

Single Asset / Single Borrow (SASB)
Collateral consists of a single large "trophy" property or a portfolio of assets owned by the same borrower

Agency CMBS
CMBS issued by Fannie Mae or Freddie Mac backed exclusively by mortgages on apartments

CMBX
Conduit CMBS index exposure. Credit default swap contracts that reference baskets of 25 underlying bonds.

CMBS takes a variety of forms—from diversified pools of loans backing conduit CMBS to issuances secured by a single property in SASB deals. The credit profiles of bonds from these issuances range from below investment grade all the way to agency-guaranteed AAA. This variety allows investors to choose their desired risk-return profile within a given sub-sector, as shown in Exhibit 1.

Investors can tailor their interest rate risk because these subsectors also carry a range of duration characteristics, as shown in Exhibit 2. Finally, investors can manage their property-type exposure by introducing multiple subsectors. For example, agency CMBS offers a pure-play apartment exposure. And SASB can help target or avoid certain property types.

EXHIBIT 1: CMBS sub-sectors offer a range of risk-return options

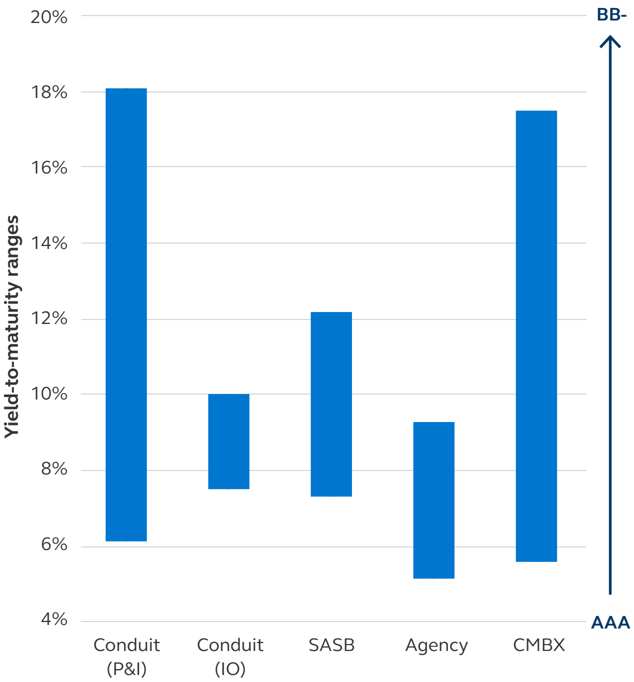
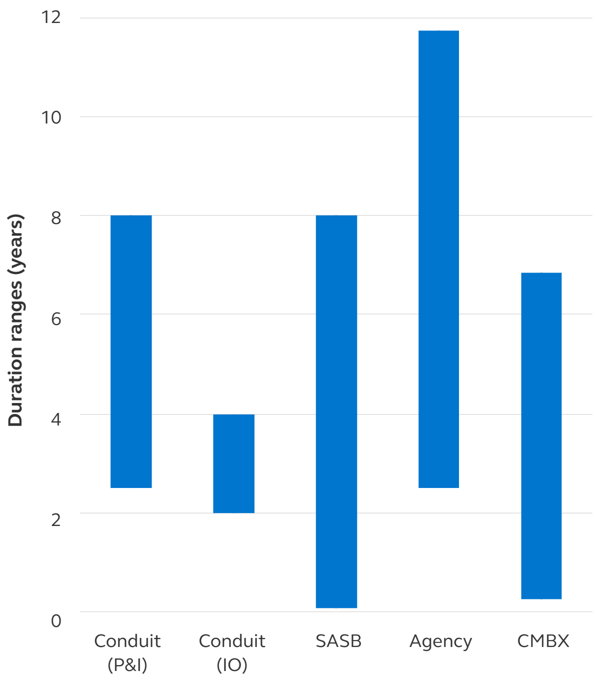


EXHIBIT 2: Interest-rate sensitivity options from floating-rate to long-duration



As of 30 September 2023.
Sources: J.P. Morgan, IHS Markit, Principal Asset Management
P&I = Principal & Interest bonds
IO = Interest Only strips

The versatility of CMBS makes it useful for potentially meeting a wide-range of specific investor needs. It also provides investors the possible flexibility to adapt as economic conditions evolve. To position defensively, opportunistically, or anywhere in between, depending on the macro outlook and the level of available market risk premiums.

Versatility of CMBS meets specific investor needs

Insurance companies rely on pre-payment protection and yield enhancement for asset-liability matching.

Money managers look for relative value, diversification, and alternative credit exposure versus traditional fixed income investments.

Asset allocators seek to improve the risk-return profile of broad, diversified portfolios.

Private equity managers and hedge funds can seek higher risk-return opportunities in lower-rated bonds, employ leverage, and utilize CMBX.

Pension funds may find value relative to real estate equity in opportunistic strategies.

Liability-driven investment managers can seek attractive yield enhancement and diversification at different duration points.

Position defensively, opportunistically, or anywhere in between

Defensive	⟵⟶	Opportunistic
AAA credit quality	Focus on yield enhancement	Utilize leverage
Floating-rate bonds	Interest only ("IO") strips	Capitalize on market dislocations
"Trophy" property SASB	Relative-value positioning	Below investment grade bonds
Buy protection in CMBX	Active credit management	Sell protection in CMBX

2 YIELD ENHANCEMENT

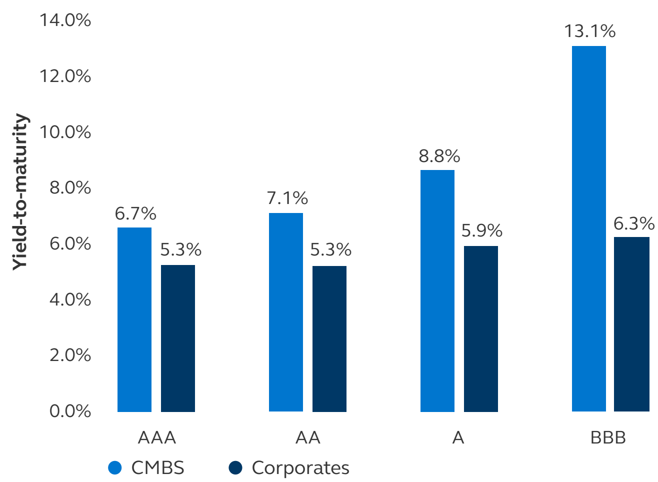
CMBS has historically traded at a spread premium relative to fixed income assets of similar rating and duration. The potential for yield enhancement increases the further an investor can venture on the ratings spectrum. However, potential is limited for investors who only tap into CMBS through aggregate fixed income allocations.

The CMBS exposure represented within the Bloomberg U.S. Aggregate Index is concentrated in AAA securities (71%) that don't add meaningful alpha, yield, or diversification to a portfolio.

Principal Asset Management selects securities from across the CMBS risk spectrum to help unlock the sector's potential benefits for investors.

With a robust process driven by our real estate knowledge and proprietary quantitative analysis, we can construct credit-centric CMBS exposures with the potential to generate more significant positive impacts on overall portfolio construction and investment outcomes.

EXHIBIT 3: CMBS provides yield enhancement relative to corporate bonds



As of 30 September 2023.
Source: J.P. Morgan, Principal Asset Management.
Indices: J.P. Morgan CMBS New Issue On-the-Run AAA/AA/A/BBB Indices, Corporates: J.P. Morgan JULI AAA/AA/A/BBB 7-10 Years.

EXHIBIT 4: Principal Balanced CMBS strategy—A value added approach

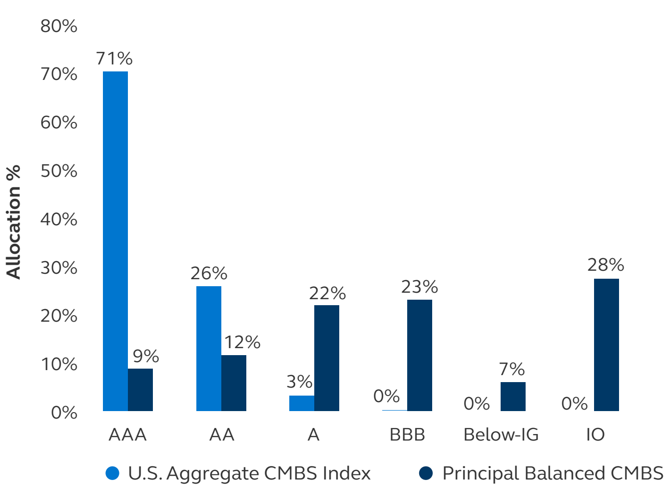
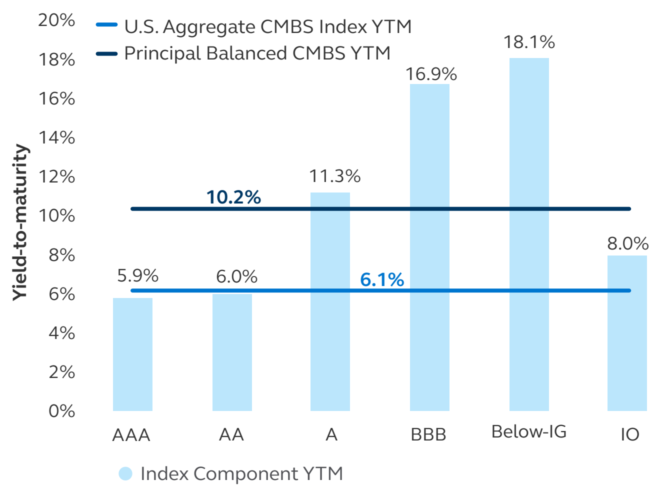


EXHIBIT 5: Yield enhancement vs. U.S. aggregate CMBS exposure



As of 30 September 2023.
Sources: Bloomberg Index Services Limited, Principal Asset Management. U.S. Aggregate CMBS Index: Bloomberg CMBS Erisa Eligible Index. Principal Balanced CMBS: Principal Balanced CMBS Yield Oriented Return Composite. Strategy allocation (Exhibit 4) and YTM (Exhibit 5) are from the representative portfolio of the Principal Balanced CMBS Yield Oriented Return Composite.

3 DIVERSIFICATION BENEFITS

CMBS credit performance is ultimately determined by the performance of the underlying commercial real estate; this creates potential diversification benefits for broader portfolios. Diversification is one reason real estate remains in demand. Notably, institutional investors have consistently raised target allocations to real estate since 2013. The recent average target allocation of over 10% reflects investor demand for the potential benefits of this alternative asset class.[1]

Low historical correlations of the Principal Balanced CMBS composite show the potential diversification benefit of including a credit-centric CMBS strategy within a fixed income allocation and beyond.

The correlation chart below also illustrates the enhanced diversification benefit presented by the Principal Balanced CMBS strategy relative to a generic U.S. aggregate CMBS exposure.

[1]Source: 2022 Institutional Real Estate Allocations Monitor, target allocations to real estate.

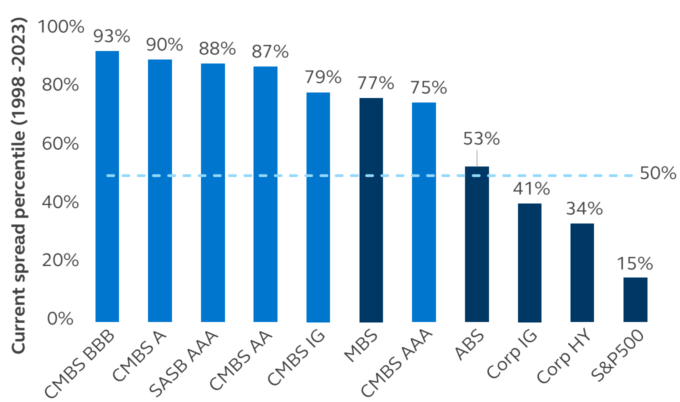
	Correlation					
2016-2023	U.S. REITs	U.S. Aggregate	Investment Grade Corporates	High Yield Corporates	Preferreds	U.S. Aggregate CMBS
Principal Balanced CMBS	0.54	0.37	0.58	0.62	0.47	0.62
U.S. Aggregate CMBS	0.47	0.92	0.89	0.54	0.64	1.00

As of 30 September 2023.
Source: Bloomberg Index Services Limited, BofaMerrill Lynch, Bloomberg, Principal Asset Management. U.S. Aggregate: Bloomberg U.S. Aggregate Index. U.S. REITs: MSCI U.S. REIT Index. Investment Grade Corporates: Bloomberg U.S. Corporate Investment Grade Index. High Yield Corporates: Bloomberg U.S. Corporate High Yield Index. Preferreds: BofAMerrill Lynch Fixed Rate Preferred Securities Index. U.S. Aggregate CMBS: Bloomberg CMBS ERISA-Eligible (Investment Grade) Index. Principal Balanced CMBS: Principal Balanced CMBS Yield Oriented Return composite. Past performance is not a reliable indicator of future performance.

WHY NOW

Commercial real estate has been negatively impacted by rising rates, challenging office fundamentals, and constrained capital markets. The public real estate markets have re-priced significantly while other markets have been slow to reflect the risks presented by the current macro environment. CMBS is exhibiting spreads and yields that look high on an absolute and relative basis. For instance, CMBS conduit single-A bond spreads are currently in the 90th percentile compared to the past 25 years, a measurement period that incorporates the GFC. While the current challenges warrant caution, generally conservative underwriting, low historic fixed rates, and a more conservative position in the capital stack contribute to interesting risk-adjusted return potential for discerning investors.

EXHIBIT 6: CMBS risk premiums are elevated relative to history and other asset classes



As of 30 September 2023.
Sources: Bloomberg Index Services Limited, J.P. Morgan, Bloomberg, Principal Asset Management.

A compelling case

The versatility of CMBS, along with its potential for yield enhancement and diversification benefits, make a compelling case: a stand-alone allocation to a credit-centric CMBS strategy may improve a portfolio risk-return profile relative to one without that allocation.

Why Principal Asset Management

In a diverse asset class where risk is tied to specific properties, locations, tenants, and real estate markets, we believe security selection with disciplined surveillance is fundamental to the goal of achieving consistent outperformance.

Our CMBS team's investment philosophy and process is rooted in real estate and expressed through our understanding of structured product, directly integrating the breadth and depth of Principal Asset Management's four quadrant real estate capabilities and expansive fixed income operations.

Four quadrant real estate experience	We invest in all four quadrants of commercial real estate, spanning public and private debt and equity.
Specialized CMBS team	8 investment professionals dedicated to CMBS, managing investment strategies ranging from buy-and-hold to opportunistic, comprising $5.8 billion in assets.[1]
Integrated investment process	The CMBS investment process incorporates loan-level feedback from our 35+ commercial mortgage underwriters. Top-down macro scenario analysis overlays our bottom-up analysis.
Proprietary default model and independent research	Our proprietary default model allows us to analyze a full distribution of potential bond returns based on 2,000 different economic scenarios. We've modeled every fixed-rate conduit CMBS issuance since 1999. Today, we conduct independent research on more than 350 CMBS issuances every year.

> "Our ability to analyze the underlying commercial real estate properties, our access to real estate debt and equity professionals, and our proprietary modeling capability help our team meet clients' specific investment objectives."

Marc Peterson,
Chief Investment Officer - CMBS, Principal Asset Management

[1] As of 30 September 2023.

Risk Considerations

Past performance is no guarantee of future results and should not be relied upon to make an investment decision. Investing involves risk, including possible loss of principal. Fixed-income investment options that invest in mortgage securities, such as commercial mortgage-backed securities, are subject to increased risk due to real estate exposure. Commercial Mortgage Backed Securities carry greater risk compared to other securities in times of market stress and are not suitable for every investor. The value and price of these securities is sensitive to conditions affecting the real estate market and the assets underlying these securities. Accordingly, changes in economic conditions, the value of underlying assets, credit conditions, interest rates, or other factors can cause these securities to diminish in value. The risk of investment losses in trading in futures, CDX, CDS, and swaps, can be substantial. You should therefore carefully consider whether such trading strategy is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in this trading can work for or against the investor. Asset allocation and diversification do not ensure a profit or protect against a loss.

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The two methods of calculating performance of the composite and the index may not be identical and it is not possible to invest in an index. Indices are unmanaged and do not take into account fees, expenses and transaction costs are not available for direct investment.

Representative portfolio information of the Principal Balanced CMBS Yield Oriented Return composite is shown for illustrative and example purposes only. Actual client portfolios may differ as a result of account size, client-imposed investment restrictions, the timing of client investments and market, economic and individual company considerations. Management and performance of individual accounts may vary for reasons that include the existence of different implementation practices and model requirements in different investment programs

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